1983

Proposed statement of position : reporting by banks of investment securities gains or losses;Reporting by banks of investment securities gains or losses; Exposure draft (American Institute of Certified Public Accountants), 1983, Apr. 22

American Institute of Certified Public Accountants. Banking Committee

EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION

REPORTING BY BANKS OF INVESTMENT SECURITIES GAINS OR LOSSES

APRIL 22, 1983

Prepared by the Banking Committee of the
American Institute of Certified Public Accountants

Comments should be received by July 22, 1983, and addressed to
Craig A. Mason, Technical Manager, Federal Government Division, AICPA,
1620 Eye Street, N.W., Washington, D.C. 20006

NOTICE OF PUBLIC HEARING

The AICPA Banking Committee will hold a public hearing on the issues raised in this proposed statement of position.

The hearing will be held on Monday, August 1, 1983, between 9:30 a.m. and 5:30 p.m. at the office of the American Institute of Certified Public Accountants in New York.

Those who wish to make oral presentations should observe the following procedures:

July 20, 1983	Notification in writing of intent to make an oral presentation, including the names of individuals who will make the presentation, the organization they represent (if any), and the amount of time desired.
July 22, 1983	Submission of written comments or summaries of proposed oral presentations.

Those who do not desire to make oral presentations but wish to submit written comments should do so by August 1, 1983.

Requests to make an oral presentation and written comments and summaries should be addressed to

Craig A. Mason, Technical Manager
Federal Government Division
American Institute of CPAs
1620 Eye Street, N.W.
Washington, D.C. 20006

Written comments concerning this proposed statement of position will be available for inspection at the AICPA Washington office and copies will be available for a reasonable fee.

SUMMARY

This statement of position provides guidance for bank reporting of investment securities gains or losses in the income statement.

The AICPA Banking Committee recommends the following:

- Net investment securities gains or losses should be presented on a separate line, on a pretax basis, in the "other income" section of a bank's income statement. If not material, they may be included in "other income."
- Prior periods' interim and annual financial statements should be restated to conform with the one-step format.
- If significant to an understanding of the revised reporting format, the tax effect of securities gains or losses should be disclosed in a note to the financial statements.

The provisions of this statement would be effective for periods ending on or after December 31, 1983.

AICPA

American Institute of Certified Public Accountants

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

April 22, 1983

Accompanying this letter is an exposure draft of a proposed statement of position, Reporting by Banks of Investment Securities Gains or Losses. A summary of the proposed SOP also accompanies this letter.

Comments or suggestions on any aspect of this exposure draft will be appreciated. The consideration of responses will be helped if the comments refer to the specific paragraph numbers and include reasons for any suggestions or comments.

Comments on this exposure draft should be sent to Craig A. Mason, Technical Manager, Federal Government Division, AICPA, 1620 Eye Street, N.W., Washington, D.C. 20006, in time to be received by July 22, 1983.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the Washington office of the American Institute of Certified Public Accountants after August 10, 1983, for one year.

Sincerely,

Roger Cason

Roger Cason
Chairman
Accounting Standards Executive Committee

Thomas H. Asson

Thomas H. Asson
Chairman
Banking Committee

PROPOSED STATEMENT OF POSITION

REPORTING BY BANKS OF INVESTMENT SECURITIES GAINS OR LOSSES

BACKGROUND

1. The format of banks' income statements has been periodically reviewed, discussed, and revised by bank regulators, the Securities and Exchange Commission, and the accounting profession during the last sixteen years. Although general agreement has evolved on most issues, the method of reporting realized investment securities gains or losses remains controversial.

2. The issue was first addressed by the AICPA Committee on Bank Accounting and Auditing in the 1968 audit guide, *Audits of Banks*, which was amended by a supplement in December 1969. The amended guide recommended the following:

- Securities gains or losses less related income tax effects should be reported below "income before securities gains (losses)"; such gains or losses are to be included in the determination of net income.
- Earnings per share may be reported for income before securities gains or losses as well as for net income.

Since 1969, this two-step format has been followed for both regulatory and stockholder reporting purposes.

3. In April 1977 the SEC proposed, in a revision of Article 9 of Regulation S-X, that the two-step format be eliminated. The AICPA Banking Committee responded positively to this SEC proposal in a letter dated July 1, 1977. However, as a result of a significant number of negative responses from the banking industry, the SEC decided not to adopt the proposal at that time.

4. For the past several years the AICPA Banking Committee has been preparing a revised *Audits of Banks*. This revised audit guide, issued in February 1983, includes an illustrative income statement using the two-step format for reporting investment securities gains or losses.

5. In a July 1982 revision of Article 9 of Regulation S-X, the SEC again proposed the elimination of the two-step format. On October 13, 1982, the AICPA Banking Committee responded to the proposal, stating in part:

> Although there are substantive arguments for including securities gains or losses as another item of income and not in a separate section of a two-step income statement, we believe this issue should be resolved by the FASB. . . . To assist the FASB in this process, the committee established a special task force to draft a statement of position addressing this issue. . . .

On March 7, 1983, the SEC adopted final rules amending Article 9 of Regulation S-X requiring the use of the one-step format for all bank holding company filings effective for fiscal years ending on or after December 31, 1983, with earlier application permitted.

RATIONALE FOR THE TWO-STEP FORMAT

6. The impetus for the two-step format can be traced back to the income tax law in effect before July 12, 1969. This law provided that if securities transactions in a particular year resulted in a net gain, the gain would be taxed at capital gain rates; a net securities loss would be deductible from ordinary income. Accordingly, banks attempted to realize their gains in "net bond gain years" and their losses in "net bond loss years." Banks argued that including such gains and losses in "operating" earnings would cause reported earnings to fluctuate in an arbitrary, tax-driven manner.

7. Since 1969 two developments have mitigated the potential for fluctuations. First, the income tax law was amended effective July 12, 1969, resulting in the inclusion of both gains and losses in ordinary income. Second, generally increasing interest rates have reduced the market value of some investment securities below book value, thus often limiting the opportunity to realize gains.

8. Proponents of the two-step format argue that including investment gains and losses in operating earnings provides an opportunity to manage earnings, because the securities sold and the timing of the sales are at the discretion of management. Proponents also fear that banks may be reluctant to absorb losses as a charge against current earnings, although reinvestment of the proceeds at higher yields is in their long-term economic interest.

9. In connection with the second concern, some proponents believe that changing the reporting format may affect the way funds are invested. For example, bankers might be reluctant to invest in securities with fixed rates of return for extended time periods. Irreparable damage might be done to the market for long-term state and municipal obligations if banks shift funds to shorter term U.S. Treasury bills and other U.S. government obligations.

10. It is also argued that since the gain or loss generally represents an adjustment of the yield to maturity of the related security, it should be spread over some future period rather than be charged or credited entirely to the current period. This view supports deferral and amortization, which are not acceptable under generally accepted accounting principles. As an alternative, the two-step income statement is considered a more meaningful presentation of short-term operating results (income before securities gains or losses) and longer term results (net income) than the one-step format.

11. Finally, it is argued that there is no compelling reason to change because the current format has been in use for many years and is well understood by readers of bank financial statements.

RATIONALE FOR THE ONE-STEP FORMAT

12. Although investment securities are generally purchased as long-term investments, they may be sold for tax planning, liquidity, or portfolio restructuring purposes. Accordingly, proponents of the one-step format believe that securities gains or losses should be included in operating earnings because they are an integral part of a bank's operations. Proponents also note that the current two-step format presents securities gains or losses in effect as extraordinary items; such gains or losses generally do not meet the extraordinary item classification criteria in Accounting Principles Board Opinion no. 30, *Reporting the Results of Operations*.

13. Banks report income before securities gains or losses and net income with equal prominence in their income statements. However, the thrust of other reporting — press releases, the chairman's letter to stockholders, management's discussion and analysis of earnings included in financial reports, and newspaper articles — generally emphasizes income before securities gains or losses. As a result, there is concern that banks presently are in a position to manage earnings by realizing losses, reporting them "below the line," and investing the proceeds at higher yields, thereby reporting improved future earnings "above the line."

14. Proponents of the one-step format point out that other nonrecurring gains or losses from the sale of bank assets are included in operating earnings. In recent years these assets have included equity securities and real estate acquired in satisfaction of loans, main office and branch bank buildings, the residual value of leased assets, and portions of the loan portfolio. The timing of the transactions is somewhat discretionary, similar to that of investment securities transactions. Accordingly, there appears to be little justification for classifying and reporting investment securities transactions separately.

15. Proponents of the one-step format discount the concern that irreparable damage will be done to the market for long-term state and municipal obligations. They contend that investment decisions are more likely to be based on economic concerns than on accounting results. For example, they believe that the current period of volatile high interest rates has already adversely affected the market for all long-term fixed-rate securities.

16. Finally, proponents of the one-step format point out that most other types of business enterprises use the one-step approach in reporting their operating results, and they see no continuing theoretical reason to make an exception for banks.

RECOMMENDATIONS OF THE BANKING COMMITTEE

17. The AICPA Banking Committee recommends the following:

- Net investment securities gains or losses should be presented on a separate line, on a pretax basis, in the "other income" section of a bank's income statement. If not material, they may be included in "other income."
- Prior periods' interim and annual financial statements should be restated to conform with the one-step format.
- If significant to an understanding of the revised reporting format, the tax effect of securities gains or losses should be disclosed in a note to the financial statements.

RATIONALE FOR THE RECOMMENDATIONS

18. The committee acknowledges arguments supporting both the two-step and the one-step formats. However, the committee concludes the following:

- Investment securities transactions are an integral part of a bank's operations.
- Potential presently exists for realizing losses below the line to report improved future earnings above the line.
- Nonrecurring gains or losses on the sale of other bank assets are currently reported above the line.
- Some of the original reasons for reporting securities gains or losses below the line are no longer valid. There is little remaining justification for continuing to make an exception for banks in reporting earnings using the two-step income statement format.

EFFECTIVE DATE AND TRANSITION

19. The committee recommends that the provisions of this statement of position should apply to bank income statements issued for periods ending on or after December 31, 1983. Comparative income statements of prior periods should be restated to comply with the provisions of this statement of position.

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